

*Mastrobuono v. Shearson Lehman Hutton, Inc.**

In *Mastrobuono v. Shearson Lehman Hutton, Inc.*,¹ the United States Supreme Court overturned a Seventh Circuit decision vacating an arbitrator's punitive damage award against a securities broker.² This case arose from alleged mishandling of a securities account by the respondent.³ Petitioners asserted a variety of state and federal causes of action in a lawsuit filed in the Northern District of Illinois.⁴ Pursuant to the "Client's Agreement" contract signed by petitioners Antonio and Diana Mastrobuono, respondents moved to compel arbitration under sections 3 and 4 of the Federal Arbitration Act.⁵ The Client's Agreement⁶ allowed the client to choose the procedural rules for the arbitration itself.⁷ The Client's Agreement did not have an option for the choice of law. Any litigation or arbitration was required to "be governed by the laws of the State of New

* 115 S. Ct. 1212 (1995).

¹ *Id.*

² See *Mastrobuono v. Shearson Lehman Hutton, Inc.*, 20 F.3d 713 (7th Cir. 1994).

³ Petitioners alleged that respondents had engaged in churning, unauthorized trading and margin exposure. See Petitioner's Brief at 6, *Mastrobuono* (No. 94-18). Churning occurs when there is "excessive trading in a stock investment account in order to generate commissions for a broker . . ." BARRON'S LAW DICTIONARY 71 (3d ed. 1991). As a result of Respondent's alleged actions, Petitioners suffered "substantial losses." Petitioner's Brief at 6, *Mastrobuono* (No. 94-18).

⁴ Petitioners alleged that respondent had violated: (1) SEC Rule 10b-5 and § 15(c)(1) of the Securities Exchange Act of 1934; (2) federal and state RICO statutes; (3) Illinois Securities law and (4) Illinois Consumer Fraud and Deceptive Business Practices Act. See Petitioner's Brief at 6-9, *Mastrobuono* (No. 94-18). Petitioner also included common law claims for breach of contract, breach of fiduciary duty, fraud, misrepresentation and negligence. See *id.*

⁵ 9 U.S.C. §§ 1-14 (1994).

⁶ The relevant paragraph in the Client's Agreement states:

This agreement shall inure to the benefit of your [Shearson's] successors and assigns[,] shall be binding on the undersigned, [Mastrobuonos'] heirs, executors, administrators and assigns, and shall be governed by the laws of the State of New York. Unless unenforceable due to federal or state law, any controversy arising out of or relating to [Mastrobuonos'] accounts, to transactions with you, your officers, directors, agents and/or employees for me or to this agreement or the breach thereof, shall be settled by arbitration in accordance with the rules then in effect, of the National Association of Securities Dealers, Inc. or the Boards of Directors of the New York Stock Exchange, Inc. and/or the American Stock Exchange, Inc. as I may elect.

Mastrobuono, 115 S. Ct. 1212, 1216-1217 n.2.

⁷ The client was allowed to choose the arbitration rules from one of the three following organizations: (1) the National Association of Securities Dealers, (2) the New York Stock Exchange or (3) the American Stock Exchange.

York."⁸

Petitioners failed to specify which set of procedural rules should apply in arbitration.⁹ This allowed respondents to choose the National Association of Securities Dealers' (NASD) procedural rules for the arbitration.¹⁰ The parties arbitrated the dispute according to the procedural rules of the NASD and the substantive law of New York.¹¹ After hearing all evidence, the arbitration panel awarded \$159,327 in compensatory damages and \$400,000 in punitive damages to petitioners.¹²

Respondents contested the punitive damages award in the Northern District of Illinois, claiming that the arbitration panel had exceeded its power. Respondents did not contest the compensatory damage award and promptly paid the \$159,327 compensatory damage award.¹³ Noting that the parties had agreed to follow New York law, the district court held that the arbitrators had exceeded their authority.¹⁴ New York provides that only courts may grant punitive damages. Arbitrators are expressly forbidden from awarding punitive damages.¹⁵ The Seventh Circuit affirmed the district court's decision.¹⁶ The Supreme Court granted *Certiorari*¹⁷ in order to address the split among the circuits¹⁸ on the power of choice of law

⁸ *Mastrobuono v. Sherson Lehman Hutton, Inc.*, 812 F. Supp. 845, 846 (N.D. Ill. 1993).

⁹ See *Mastrobuono*, 115 S. Ct. at 1217.

¹⁰ See *id.* at 1218.

¹¹ See *id.*

¹² See Petitioner's Brief at 10, *Mastrobuono* (No. 94-18).

¹³ See *Mastrobuono*, 115 S. Ct. at 1215.

¹⁴ See *Mastrobuono*, 812 F. Supp. at 848.

¹⁵ See *Garrity v. Lyle Stuart, Inc.*, 353 N.E.2d 793 (1976).

¹⁶ See *Mastrobuono*, 20 F.3d at 713.

¹⁷ *Mastrobuono v. Shearson Lehman Hutton, Inc.*, 115 S. Ct. 305 (1994).

¹⁸ The circuits were split into two groups before the *Mastrobuono* decision. One group of circuits deferred to the parties' choice of law clause and disallowed punitive damages. This group included the Second and Seventh Circuits. See, e.g., *Barbier v. Shearson Lehman Hutton, Inc.*, 948 F.2d 117 (2d Cir. 1991); *Pierson v. Dean, Witter, Reynolds, Inc.*, 742 F.2d 334 (7th Cir. 1984).

The second group of circuits held that punitive damages were available regardless of the parties' choice of law. These circuits held that the FAA preempted state law on the issue of punitive damages. These circuits included the First, Eighth, Ninth and Eleventh Circuits. See, e.g., *Lee v. Chica*, 983 F.2d 883 (8th Cir.), *cert. denied*, 114 S. Ct. 287 (1993); *Todd Shipyards Corp. v. Cunard Line, Ltd.*, 943 F.2d 1056 (9th Cir. 1990); *Raytheon Co. v. Automated Business Systems, Inc.*, 882 F.2d 6 (1st Cir. 1989); *Willoughby Roofing and Supply Co. v. Kajima Int'l, Inc.*, 776 F.2d 269 (11th Cir. 1985). For detailed comparison of these cases, see Heather J. Haase, Note, *In Defense of Parties' Rights to Limit Arbitral*

provisions to preclude an arbitral award of punitive damages that would otherwise be proper.¹⁹

The Supreme Court held by a vote of 8-1 that the contract was ambiguous on the issue of punitive damages. Under existing precedent, ambiguities in the contract are read in favor of arbitration.²⁰ As such, the Supreme Court interpreted the Client's Agreement as allowing punitive damages. *Volt Information Sciences, Inc. v. Board of Trustees of Leland Stanford Junior University*,²¹ the primary background case, is factually similar to *Mastrobuono*. In *Volt*, Stanford University brought action against a contractor for fraud and breach of contract.²² The contract included an arbitration clause which mandated arbitration under the law of "the place where the Project is located."²³ In this case, the project took place in California, therefore California law was used. Under California law, any party may stay arbitration when the litigation involves parties who are not subject to the arbitration.²⁴

Volt moved to compel arbitration under California arbitration law.²⁵ California law did not permit arbitration when the case involved parties who had not consented to arbitration. Based on this, the California Court of Appeals upheld the lower court's ruling refusing to compel arbitration.²⁶ The California Supreme Court denied review of this case.²⁷

The United States Supreme Court upheld the California Court of Appeals. The California Court of Appeals held that the parties had intended to use California arbitration law.²⁸ The United States Supreme Court relied on the California court's interpretation of the contract because "the interpretation of private contracts is ordinarily a question of state

Awards Under the Federal Arbitration Act: Mastrobuono v. Shearson Lehman Hutton, Inc., 31 WAKE FOREST L. REV. 309, 322-330 (1996).

¹⁹ See *Mastrobuono*, 115 S. Ct. at 1215.

²⁰ See *Moses H. Cone Mem'l Hosp. v. Mercury Constr. Corp.*, 460 U.S. 1, 24-25 (1983) (holding that section 2 of the FAA requires that "any doubts concerning the scope of arbitrable issues should be resolved in favor of arbitration").

²¹ 489 U.S. 468 (1989).

²² See *id.* at 470.

²³ *Id.* at 472.

²⁴ See *id.* at 471 (citing CAL. CIV. PROC. CODE ANN. § 1281.2(c) (West 1982)).

²⁵ See *id.*

²⁶ See *id.*

²⁷ See *id.* at 473.

²⁸ Justices Brennan and Marshall disagreed strongly with this assessment. Arguing that interpretation of arbitration clauses intertwined federal and state law, these dissenting Justices felt that the Supreme Court should be able to review the lower court decision. See *id.* at 487-488.

law"²⁹ Thus, the question in *Volt* involved the power of parties to set the rules of the arbitration through a choice of law clause.

The Supreme Court held that parties can choose the substantive laws and rules for an arbitration through a choice of law clause. The Court based this decision on the proposition that the primary purpose of the Federal Arbitration Act is to enable parties to enforce arbitration agreements according to their terms. Thus, if parties wish to use the laws of a specific jurisdiction, arbitrators and courts are obligated to use the laws of that jurisdiction. "Just as they may limit by contract the issues which they will arbitrate, so too may they specify by contract the rules under which that arbitration will be conducted."³⁰

Volt provided the backdrop for the *Mastrobuono* case. *Volt* established that courts are obligated to enforce choice of law clauses in arbitration agreements. The Supreme Court, although using the same law as in *Volt*, came up with a very different result. In an 8-1 vote, the Supreme Court held that the arbitration agreement was ambiguous regarding the power of the arbitration panel to award punitive damages. Justice John Paul Stevens wrote the opinion for the majority and Justice Clarence Thomas wrote the dissenting opinion.

At first blush, it does not appear that the Supreme Court created any new law in this area. The Court relied on existing precedents and common law doctrines in order to decide this case. The Court rejected petitioners request that the Federal Arbitration Act be extended to pre-empt all state arbitration law, even when the parties have chosen that state's laws by contract.³¹ The Court felt that the "central purpose of the Federal Arbitration Act [is] to ensure 'that private agreements to arbitrate are enforced according to their terms.'"³² Therefore, if the parties agreed to limit arbitration by using New York law, the courts are required to enforce that agreement.³³

The rest of the Court's opinion was a *de novo*³⁴ examination of whether

²⁹ *Id.* at 474.

³⁰ *Id.* at 479 (citations omitted).

³¹ See, e.g., *Allied-Bruce Terminix Cos. v. Dobson*, 115 S. Ct. 834 (1995) (holding that the FAA preempts all state law on the issue of arbitrability).

³² *Mastrobuono*, 115 S. Ct. at 1214 (citing *Volt*, 489 U.S. at 479).

³³ See *Mastrobuono*, 115 S. Ct. at 1216 ("In other words, if the contract says 'no punitive damages,' that is the end of the matter, for courts are bound to interpret contracts in accordance with the expressed intentions of the parties—even if the effect of those intentions is to limit arbitration.").

³⁴ See *Mastrobuono*, 115 S. Ct. at 1217 n.4. This contrasts with the situation in *Volt*, where the Supreme Court granted deference to the California Court of Appeal's interpretation of the contract. See *id.*; *supra* note 28 and accompanying text.

the parties agreed to exclude punitive damages. After exploring the contract clause, New York law and the NASD rules, the Court concluded that the contract was ambiguous on the issue of punitive damages. This ambiguity arose from a conflict between the choice of law provision and a handbook given to NASD arbitrators. The Court felt that a clause in the handbook indicated that NASD arbitrators were allowed to award punitive damages. The clause in question states that "[t]he issue of punitive damages may arise with great frequency in arbitrations. Parties to arbitration are informed that arbitrators can consider punitive damages as a remedy."³⁵

This statement led the Court to find that the text of the arbitration clause does not indicate that the parties had chosen to rule out punitive damages. "[T]he text of the arbitration clause itself surely does not support—indeed, it contradicts—the conclusion that the parties agreed to foreclose claims for punitive damages."³⁶ At best, the Court felt that the arbitration clause was ambiguous as to the role of punitive damages. There were no relevant NASD procedural rules that prevented punitive damages.³⁷

Once the Court determined that the arbitration clause was ambiguous, the Court used two common law doctrines of contract interpretation. The first doctrine was construing ambiguous language against the drafter. The purpose of this rule is to protect a party who did not draft a document from unintended or unfair results.³⁸ The Court argued that this purpose is particularly relevant to this case. The petitioners signed a standard form contract in which they implicitly waived their right to punitive damages.

The second common law rule of contract interpretation that the Supreme Court used is the doctrine of reading a document to give effect to all provisions and render them consistent with each other.³⁹ As such, the Supreme Court interpreted the choice of law provision as incorporating all substantive New York law except for New York's laws which limit the authority of arbitrators. The arbitration clause incorporates the NASD rules

³⁵ *Mastrobuono*, 115 S. Ct. at 1218.

³⁶ *Id.*

³⁷ The NASD has since amended its rules on punitive damages. Rule 21(f)(4) of the NASD Rules of Fair Practice now reads "[n]o agreement [between a member and a customer] shall include any condition which . . . limits the ability of a party to file any claim in arbitration or limits the ability of the arbitrators to make any award." *Mastrobuono*, 115 S. Ct. at 1218 n.6. This rule went into effect for contracts executed after September 7, 1989. *See id.*

³⁸ *See Mastrobuono*, 115 S. Ct. at 1219 (citing RESTATEMENT (SECOND) OF CONTRACTS § 206 cmt.a (1979)).

³⁹ *See id.* (citing RESTATEMENT (SECOND) OF CONTRACTS § 203(a) & cmt. b (1979), other citations omitted).

of arbitration, including the purported allowance of punitive damages.⁴⁰

Finally, the majority relied on the doctrine that any "ambiguities as to the scope of the arbitration clause itself [must be] resolved in favor of arbitration."⁴¹ Thus, the majority argued that when there is ambiguity as to the power of arbitrators to grant punitive damages, courts are obligated to allow arbitrators to exercise those powers.

The Court's analysis of the Client's Agreement is flawed. As Justice Thomas pointed out in his lone dissent, this handbook was not a part of the NASD procedural rules for arbitration. In fact, the handbook was not promulgated by the NASD at all. It was created by the Securities Industry Conference on Arbitration (SICA).⁴² In other words, the majority relied on a handbook created by a separate organization,⁴³ and treated that handbook as acting as precedent.

The majority also misrepresented the nature of the handbook itself. The handbook was an instructional manual which offered suggestions about how NASD arbitrators should conduct themselves during arbitrations.⁴⁴ Moreover, the Supreme Court engaged in selective editing of the handbook's statement about punitive damages. The complete statement from the handbook follows:

The issue of punitive damages may arise with great frequency in arbitrations. Parties to arbitration are informed that arbitrators can consider punitive damages as a remedy. Generally, in court proceedings, punitive damages consist of compensation in excess of actual damages and are awarded as a form of punishment against the wrongdoer. If punitive damages are awarded, the decision of the arbitrators should clearly

⁴⁰ See *id.*

⁴¹ *Id.* at 1218 (citing *Volt*, 489 U.S. at 476; *Moses H. Cone Mem'l Hosp. v. Mercury Constr. Corp.*, 460 U.S. 1, 24-25 (1983)) (internal quotation marks omitted).

⁴² See *id.* at 1222 (Thomas, J., dissenting) (citing SECURITIES INDUSTRY CONFERENCE ON ARBITRATION, *ARBITRATOR'S MANUAL* (1992) [hereinafter *SICA ARBITRATOR'S MANUAL*]).

⁴³ One commentator has argued that Congress has implicitly delegated rulemaking authority to SICA. That commentator's argument is premised on the notion that to the extent that the SEC has consented to the SICA's interpretation of an arbitrators right to give punitive damages, SICA is persuasive authority. See Denise M. Barton, Comment, *The Evolution of Punitive Damage Awards in Securities Arbitration: Has the Use of Punitive Damages Rendered the Arbitration Forum Inequitable?*, 70 TUL. L. REV. 1537, 1546 (1996).

⁴⁴ Justice Thomas pointed out a number of examples which demonstrate the true nature of the handbook. For instance, the handbook suggested that arbitrators maintain a "poker face" during questioning of a witness. See *Mastrobuono*, 115 S. Ct. at 1222 (Thomas, J., dissenting). Also, the handbook recommended that the arbitrator should not permit "shouting, profanity or gratuitous remarks" *Id.* at 1222 n.3 (Thomas, J. dissenting).

specify what portion of the award is intended as punitive damages, and the arbitrators should consider referring to the authority on which they relied.⁴⁵

The handbook actually stated that the arbitrator should cite to authority when punitive damages were awarded and should specify what amount of the award was for punitive damages. When read in context, the handbook belied the notion that the arbitrator had the inherent power to grant punitive damages.

What is most notable about this case is what it does not do. First and foremost, this case does not wholly extinguish state law on arbitration. Petitioners had requested that the Supreme Court, in essence, hold that courts can not enforce choice of law clauses in arbitration agreements. The Supreme Court refused to do this. The Court chose instead to enforce the choice of law clause, because that was what the parties had agreed to. Then the Court engaged in very creative contract analysis to find ambiguity where none really existed.

At first blush, this case appears to have little or no precedential effect.⁴⁶ Justice Thomas argued that this case was only binding on this specific agreement. "This case amounts to nothing more than a federal court applying Illinois and New York contract law to an agreement between parties . . . [T]he majority's interpretation of the contract represents only the understanding of a single federal court regarding the requirements imposed by state law."⁴⁷ Justice Thomas was incorrect on the impact of this case.

Justice Thomas did not recognize that this case would be applied to other contracts with similar language. In fact, most securities brokerage firms have similar choice of law provisions.⁴⁸ There have already been a number of cases in which courts have upheld the awarding of punitive damage awards against securities brokerage houses solely on the basis that the language in the arbitration agreement was identical or virtually identical to the language in *Mastrobuono's* arbitration.⁴⁹ So long as aggrieved plaintiffs bring their claim in federal court, it is impossible for securities

⁴⁵ *Mastrobuono*, 115 S. Ct. at 1222 (quoting SICA ARBITRATOR'S MANUAL, *supra* note 42, at 21).

⁴⁶ But see Richard A. Booth, *Punitive Damages and Securities Arbitration in the Wake of Mastrobuono*, 9 INSIGHTS: THE CORP. & SEC. L. ADVISOR 20, 20 (1995).

⁴⁷ *Mastrobuono*, 115 S. Ct. at 1223 (Thomas, J., dissenting).

⁴⁸ See Paul Lansing & John D. Bailey, *The Future of Punitive Damage Awards in Securities Arbitration Cases After Mastrobuono*, 8 DEPAUL BUS. L.J. 201, 220 (1996).

⁴⁹ See, e.g., *Davis v. Prudential Sec., Inc.*, 59 F.3d 1186, 1189 (11th Cir. 1995); *Smith Barney, Inc. v. Schell*, 53 F.3d 807, 809 (7th Cir. 1995); *Kelley v. Michaels*, 59 F.3d 1050, 1055 (10th Cir. 1995); *PaineWebber, Inc. v. Landay*, 903 F. Supp. 193 (D. Mass. 1995).

dealers to avoid punitive damages through a choice of law clause.⁵⁰

The other impact is more subtle. The Court is sending a message to contract drafters and lower courts. That message is that courts should rigorously examine any contract that limits damages that an arbitrator may award through a choice of law provision. In other words, if the parties want to exclude punitive damages, they should clearly state their intention to do so. At least one circuit has expressly stated that *Mastrobuono* requires that arbitrators have the power to award punitive damages unless the parties unequivocally state otherwise.⁵¹ As mentioned above, *Mastrobuono* has the effect of leaving state law alive. Parties may still choose to use the arbitration law of a specific state. This presents a danger that, thus far, has remained unmentioned. The Court has recently made it clear that all state arbitration law is preempted by the FAA.⁵²

The *Mastrobuono* case demonstrated that there is one exception to this rule. Where the parties used a choice of law provision, that state's law will continue to be used. Because state law appears to be wholly preempted by the FAA, there is very little chance that state law that is on the books will be changed. Because there will almost never be a case arising in state court under a choice of law clause, there is little chance that state courts will overturn out-dated cases. State legislatures will be unlikely to amend their state arbitration laws, because the new laws will not have any effect. This leads to the danger.

Sophisticated parties can continue to incorporate unfavorable arbitration law into a contract through a choice-of-law clause. This problem will only become worse as the laws become older and more archaic. As a result, it is likely that archaic and out-dated arbitration laws will continue to remain on the books. The sole effect of these laws will be that sophisticated contract writers will be able to use these laws as a trap for the unwary.

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⁵⁰ In 1989, the NASD revised its "Rules of Fair Practice" to prohibit members from limiting "the ability of a party to file any claim in arbitration or [limiting] the ability of the arbitrators to make any award." *Mastrobuono*, 115 S. Ct. at 1218 n.6 (internal quotation marks and citation omitted). This rule only applied to contracts executed after September 7, 1989. For contracts executed after this date, there *will* be a clear discrepancy between NASD rules and the choice of law clause on the ability of arbitrators to award punitive damages. *Mastrobuono* will assure that arbitrators have the power to award punitive damages for these contracts as well.

⁵¹ See *Gateway Technologies, Inc. v. MCI Telecommunications Corp.*, 64 F.3d 993, 999 (5th Cir. 1995).

⁵² See *Allied-Bruce Terminix Cos. v. Dobson*, 115 S. Ct. 834 (1995) (holding that the FAA extends to the limits of the Commerce Clause).